Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author:	Assembly Revenue & Taxation Committee	Analyst:	Gail Hall	Bill Number:	AB 3078
Related Bills:	See Legislative History	Telephone:	845-7800	Amended Date:	June 19, 2008
		Attorney:	Patrick Kusiak	Sponsor:	Franchise Tax Board

SUBJECT: Modify Group Return Provisions/Real Estate Withholding For Certain Non-CA Entities/Other State Tax Credit Claims/TP Advocate Penalty Relief/Increase Threshold For Imposing Estimated Tax Penalty/Eliminate Double Inclusion Of Income

SUMMARY

This bill would do the following:

1. Allow entities to file a tax return on behalf of certain nonresidents.
2. Close loopholes in current tax withholding on the payments nonresident individuals and non-California businesses receive from the sale of California real property.
3. Extend the statute of limitations for claiming the credit for taxes paid to another state.
4. Give discretionary authority to the Taxpayers' Rights Advocate to grant relief from penalties, fees, or interest imposed on a taxpayer because of erroneous actions of the department.
5. Increase the Personal Income Tax (PIT) estimated tax penalty threshold.
6. Clarify the rules for the elimination from income of certain dividends received.

SUMMARY OF AMENDMENTS

The June 19, 2008, amendments added provisions 5 and 6 listed in the SUMMARY section. The department's analysis of the bill as amended on March 13, 2008, that discussed provisions 1 through 4 listed in the Summary section, still applies, but will not be discussed in this analysis

PURPOSE OF THE BILL

The purpose of this Franchise Tax Board sponsored bill is to do the following:

- Make filing state returns more convenient for nonresidents,
- Ensure that tax is collected on payments to certain nonresident individuals and businesses from the sale of California real property,
- Provide parity in treatment of the Other State Tax Credit (OSTC),
- Give taxpayers monetary relief from certain Franchise Tax Board (FTB) staff errors,
- Reduce the number of estimated tax penalty notices sent by the department for small penalty amounts and save resources for the department, taxpayers, and tax professionals, and
- Provide relief and fair treatment to certain entities that may have the same income taxed twice and to clarify existing law to increase compliance and reduce taxpayer conflicts and misinterpretations.

Board Position:			Legislative Director	Date
__X__ S	_______ NA	_______ NP		
_______ SA	_______ O	_______ NAR	Brian Putler	6/25/08
_______ N	_______ OUA	_______ PENDING		

EFFECTIVE/OPERATIVE DATE

If enacted in 2008, the bill would be effective January 1, 2009. The operative dates of the provisions added vary and will be addressed separately for each provision.

POSITION

Support.

On March 6, 2008, the three-member FTB voted 2-0, with the member from the Department of Finance abstaining, to sponsor the language added by provision 5 listed in the SUMMARY section. On January 31, 2007, the three-member FTB voted 2-0, with the member from the Department of Finance abstaining, to sponsor the language added by provision 6 listed in the Summary.

SUMMARY OF TECHNICAL AMENDMENTS

The operative date for this provision should be for taxable years beginning on or after January 1, 2009. Accordingly, amendment language is attached. (See Amendment 1).

SUMMARY OF ECONOMIC IMPACT

This summary of economic impact discusses all the provisions of this bill.

Summary: Estimated Revenue Impact of AB 3078 Effective January 1, 2009 Assumed Enactment Date After June 30, 2008				
Provisions	2007-08	2008-09	2009-10	2010-11
Modify Group Return				
General Fund Reserve		+$ 2,000,000	+$ 6,000,000	+$ 6,000,000
Mental Health Services		+$ 3,000,000	+$ 7,000,000	+$ 8,000,000
Real Estate Witholding				
Non-CA S Corporations		+$ 1,000,000	+$ 1,000,000	+< $ 500,000
Non-CA Partnerships		+$ 7,000,000	+$ 2,000,000	+$ 2,000,000
Installment Sales		-<$ 500,000	+<$ 150,000	+<$ 500,000
Other State Tax Credit		-<$ 250,000	-<$1,000,000	-<$1,000,000
Taxpayer Advocate Penalty Relief	-<$150,000	-<$ 150,000	-<$ 150,000	
Estimated Tax Penalty Threshold - $500			-$ 500,000	-<$ 250,000
Eliminate Double Inclusion of Income		-<$ 500,000	-<$ 500,000	-<$ 500,000
Totals: General Fund	**-$ 50,000**	**+$ 8,950,000**	**+$ 7,300,000**	**+$ 7,400,000**
Totals: Mental Health		**+$ 3,000,000**	**+$ 7,000,000**	**+$ 8,000,000**

Note: For purposes of adding totals, estimates of less than $150,000 were assumed to equal $50,000; less than $250,000 equal to $200,000; less or greater than $500,000 equal to $400,000; and less than $1,000,000 equal to $800,000.

PROVISION NO. 5: INCREASE THE PIT ESTIMATED TAX PENALTY THRESHOLD

EFFECTIVE/OPERATIVE DATE OF SOLUTION

If enacted in the 2008 legislative session, this provision of the bill would be effective on January 1, 2009, and this provision would be operative for taxable years beginning on or after January 1, 2010.

ANALYSIS

FEDERAL/STATE LAW

Existing federal law requires estimated tax payments if both of the following apply:

- Tax is expected to be at least $1,000 after subtracting withholding and credits.
- Withholding and credits are expected to be less than the smaller of 90% of current year's tax or 100% (110% for higher income taxpayers[1]) of prior years' tax.

For any PIT underpayment of estimated tax, federal law provides that a penalty equal to the current interest rate[2] will be assessed on the underpaid amount for the period of underpayment. Federal law provides an exception to the penalty if the total tax after applied credits is less than $1,000.

California law generally conforms to federal law and requires estimated tax payments if both of the following apply:

- Tax is expected to be at least $200 ($100 if married/RDP filing separate) after subtracting withholding and credits.
- Withholding and credits are expected to be less than the smaller of 90% of current years' tax, or 100% (110% for higher income taxpayers) of prior years' tax.

California law also provides an exception to the penalty. If the total tax after application of credits is less than $200 ($100 if married/RDP filing separate) for the preceding or current taxable year, a penalty is not assessed.

[1] Adjusted gross income for the prior year was more than $150,000 or $75,000 if married filing separate.
[2] The interest rate charged on underpayments of the personal income tax is 8% for the period of 1/1/08 to 6/30/08.

THIS PROVISION

This provision would increase the threshold for imposing the estimated tax penalty from $200 ($100 if married/RDP filing separate) after subtracting withholding and credits to $500 ($250 if married/RDP filing separate).

IMPLEMENTATION CONSIDERATION

Implementing this provision would require some changes to existing tax forms and instructions and information systems, which would be accomplished during the normal annual update.

TECHNICAL CONSIDERATION

The operative date for this provision should be for taxable years beginning on or after January 1, 2009. (See Amendment 1).

BACKGROUND

For the 2006 taxable year the department identified approximately 42,428 returns that had a tax liability ranging from $200 to $1,000 that were assessed the estimated tax penalty. The table below provides a breakdown of the average penalty amount for tax liabilities ranging from $200 to $1,000.

Total Tax Liability Ranges	Total Return Count	Total Estimate Penalty Amount	Average Penalty Amount
$200 - $300	5160	$46,640.07	$9.04
$301 - $400	5629	$63,635.79	$11.30
$401 - $500	5641	$71,955.48	$12.76
$501 - $600	5217	$72,289.49	$13.86
$601 - $700	5170	$72,248.74	$13.97
$701 - $800	5162	$82,242.27	$15.93
$801 - $900	5347	$91,447.76	$17.10
$901 - $1000	5102	$91,191.08	$17.87
Totals	**42,428**	**$591,650.68**	**$13.94**

FISCAL IMPACT

By increasing the threshold for imposing the estimated tax penalty to $500, each year this provision would both reduce the number of estimated tax penalties assessed and decrease the number of billing notices by approximately 16,430. As a result, the department would realize cost savings from mailing, printing, personnel, service center correspondence, and payment processing of approximately $91,300.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions below, the revenue loss from this provision would be as follows:

Estimated Revenue Impact from Increasing The Estimated Tax Penalty Threshold Operative for Tax Years BOA January 1, 2010			
Threshold	2008-09	2009-10	2010-11
$500		- $500,000	- < $250,000

This estimate does not account for changes in employment, personal income, or gross state product that could result from this provision.

Revenue Discussion

The revenue impact of this provision would be determined by the reduction in the amount of estimated tax penalties that would be assessed on PIT returns and any deceleration of revenue because some taxpayers will choose to stop making estimated tax payments.

Penalty Loss

Based on departmental data for taxable year 2006, taxpayers with total tax less credits and withholding that ranged from $201 to $500 were assessed approximately $182,000 in penalties for underpayment of estimated tax. This estimate assumes a growth of 2% in assessed penalties from 2006 to 2011, based on estimated growth in personal income tax returns filed, this would result in approximately $193,000 in penalties that would no longer be imposed for tax year 2010.

Whether the penalty is paid when the return is filed, or the taxpayer is billed and pays through collection, the penalties received will accrue back to the date the return was due, April 15, 2011. It is assumed that 95% of the amount due would ultimately be collected. This would result in a revenue loss of approximately $183,000 for the 2010 tax year ($193,000 x 95%). The first impacted tax return would be the 2010 taxable year, which cannot be filed until after January 1, 2011.

Deceleration

In addition, there would be a deceleration of revenue, as some taxpayers will choose not to make estimated tax payments because of the change in the penalty rules. It is assumed that a small percentage, approximately 5%, of these taxpayers will take advantage of this new law and reduce or eliminate their estimated payments. The amount of deceleration is shown in the table above as the 2009-10 revenue loss of approximately $500,000. There will be a slight revenue loss (less than $50,000) in subsequent years. .

Total Losses

The 2010-11 fiscal year would have a revenue loss rounded up to less than - $250,000 (penalty revenue loss of $183,000 + deceleration of $50,000 = - $233,000).

PROVISION 6: PROVIDE RULES FOR THE ELIMINATION FROM INCOME OF CERTAIN DIVIDENDS RECEIVED

EFFECTIVE/OPERATIVE DATE OF SOLUTION

If enacted in the 2008 legislative session, this provision would be effective on January 1, 2009. Certain aspects of this provision are declaratory of existing law. Other aspects of this provision would be specifically operative for taxable years beginning on or after January 1, 2008. In addition, this provision adds a no inference clause for prior years with respect to those aspects.

ANALYSIS

FEDERAL LAW

Under federal law, a group of affiliated corporations that meet certain ownership requirements may elect to file a single tax return called a consolidated tax return. In general, if a corporation owns at least 80 percent[3] of another corporation or of multiple corporations, those corporations are considered an affiliated group and can file a consolidated tax return.

A 100-percent dividend elimination is allowed to the dividend recipient (payee) if at the close of the day on which the dividend is received the payor and payee are members of the same affiliated group[4] and had been affiliated members for each day of the year preceding the date the dividends are paid.[5]

A federal regulation provides relief for dividends paid between a member of an affiliated group and a newly organized holding company of the group. The regulation provides an exception to the general rule for a newly formed corporation that fails the statute's requirement of being a member of the affiliated group for each day of the year preceding the date the dividend was paid.[6]

STATE LAW

Under state law, a group of affiliated corporations (which is determined under state law using a more than 50 percent, rather than 80 percent, ownership test) is referred to as a "commonly controlled group." Corporations in a "commonly controlled group" that meet certain requirements must file on a combined basis if they are part of a unitary business.

[3] At least 80% of the stock possessing the voting power and at least 80% of the total value of all the classes of stock. [Internal Revenue Code (IRC) section 1504(a)(2)].
[4] IRC section 243(b)(1)(A).
[5] Treasury Regulation section 1.243-4(a)(2)(ii).
[6] Treasury Regulation section 1.243-4(a)(5).

State law provides that dividends paid by one member of a combined unitary group out of "income previously described of the unitary business" to another member of the group are eliminated from the recipient's taxable income. Income "previously described of the unitary group" means income that is considered "business income" under California law and that has been assigned by use of an apportionment formula. "Nonbusiness income" by contrast is income that is assigned to a specific single entity instead of by use of an apportionment formula. The phrase "previously described of the unitary business" was clarified in *Willamette Industries, Inc.* v. *Franchise Tax Board* (1995) 34 Cal.App.4th 1396, to mean dividends paid out of earnings and profits created when the payor and payee were members of the same combined unitary group.

A "dividend" is defined as a distribution of earnings and profits by a corporation to its shareholders. "Earnings and profits" is an accounting concept meant to reflect what a corporation will have available for distribution to shareholders as a dividend at any specific time. A corporation's net profits or surplus is often referred to as earnings and profits. Under specific statutory rules, dividends are assumed to be paid first from a corporation's current earnings and profits, and thereafter from prior years' accumulated earnings and profits[7]. For California purposes, earnings and profits may be calculated as follows:

State net income after state tax adjustments
Plus: nontaxable income (i.e., intercompany dividends)
Plus: artificially created deductions (i.e., depreciation)
<u>Less: nondeductible expenses (i.e., federal income tax)</u>
Equals: State earnings and profits

Generally, a dividend received by a corporation is included in income. Dividends paid out of the earnings and profits of a member of a unitary business are eliminated from the income of the recipient corporation if the dividend was paid from the payor's earnings and profits accumulated in a year when the payor and payee of the dividends were affiliated corporations in a unitary business. The intent of the elimination was to prevent including the same income twice in determining the tax base of the unitary group return.

BACKGROUND

The literal reading of current law's dividend elimination statute[8] could be interpreted to mean the payor and/or payee must be California taxpayers before the payee may eliminate dividends received from the payor. The department has determined that the statute is unclear on its face. It has been the department's practice to allow the dividend elimination provided by the current statute regardless of whether the payor and payee are taxpayer or "non-taxpayer" members of the California combined unitary group return. Taxpayer members of the combined unitary group are those entities that are doing business in California or have qualified to do business in California and therefore are required to file a California tax return. "Non-taxpayer" members of the combined unitary group are members that have their business income included in the calculation of the combined group's taxable income, but are separately considered by California as doing business solely outside of the state and not subject to California tax.

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[7] IRC section 316(a)(2) and R&TC section 24451.
[8] Revenue and Taxation Code (R&TC) section 25106.

In addition, department staff views the current dividend elimination statute as unclear whether earnings and profits, accumulated when the payor and payee were members of a combined group taxable only outside of California, would be used in the calculation of dividend elimination. It has been the department's practice to allow the dividend elimination provided by the current statute regardless of whether the payor or payee had previously filed California returns, as long as the payor and payee filed as members of a comparable unitary business outside of California when the earnings arose.

THIS PROVISION

This provision would make the following changes to existing law:

- Conform to the department's practice that if dividends are paid from income earned in years prior to the payor and payee becoming members of a California combined group filing, dividend elimination would be allowed if the earnings and profits are from a return filed on a comparable combined unitary basis in another state that included the payor and payee.
- Conform to the department's practice that dividends paid out of the earnings and profits of a non-taxpayer member of the California combined unitary group to another non-taxpayer member of the group are eliminated from business income.
- Expand the dividend elimination rules to include dividends paid from a member of a combined unitary group to a newly formed member of the combined unitary group if the recipient has been a member of the combined unitary group from its formation to its receipt of the dividends. (See Appendix A for an example of current law and the proposed law relating to this provision.)
- Add anti-abuse provisions relating to newly formed members of a combined unitary group. Grant the Franchise Tax Board legislative rulemaking authority to adopt appropriate regulations relating to the purpose of the section, which is to prevent taxation of dividends received by a member of a unitary group where those dividends were paid from income previously described of the unitary business by another member of the same unitary group..

This provision would apply to a member of a unitary combined group whether doing business wholly within California or doing business within and outside of the state.

OTHER STATES' INFORMATION

The states surveyed include *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida and *Illinois* generally follow current federal law relating to dividends paid between members of an affiliated group. Massachusetts allows a deduction from net income equal to 95 percent of the value of all dividends received by the taxpayer if the taxpayer owns at least 15 percent of the voting stock of the corporation paying such dividends. *Michigan* and *New York* lack provisions allowing dividend received deductions, and *Minnesota* allows a dividend-received deduction between members of a unitary group calculated using a formula based on the ownership and apportionment percentage.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of Providing Rules For The Elimination From Income Of Certain Dividends Received Operative for tax years BOA 1/1/2008 Enacted after 7/01/2008		
2007-08	2008-09	2009-10
Minor*	Minor*	Minor*

* Revenue loss of less than $500,000.

Revenue Discussion

The revenue impact of this provision was estimated to be minor for the following reasons:

- The department's audit staff confirms that the inclusion of the same income twice when dividends are paid from a member of the unitary business group to a newly created member is uncommon. Most taxpayers are aware of the potential double inclusion of income in the unitary group's business income and can apply tax planning techniques to avoid the inclusion of income twice.
- The clarification of existing law relating to the earnings and profits from nontaxpayer members of a combined unitary business results in no revenue impact because the amendments conform to the department's current practice.

Even though the revenue impact of this provision was estimated to be minor, it is possible, but unlikely, that the revenue loss for a particular year may be more than minor because a taxpayer may be unaware of the inclusion of the same income twice "trap" from forming a new corporation in the unitary group.

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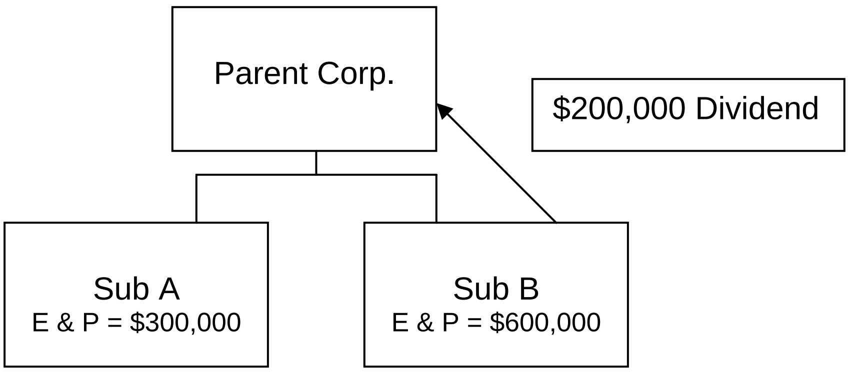
APPENDIX A
AB 1277

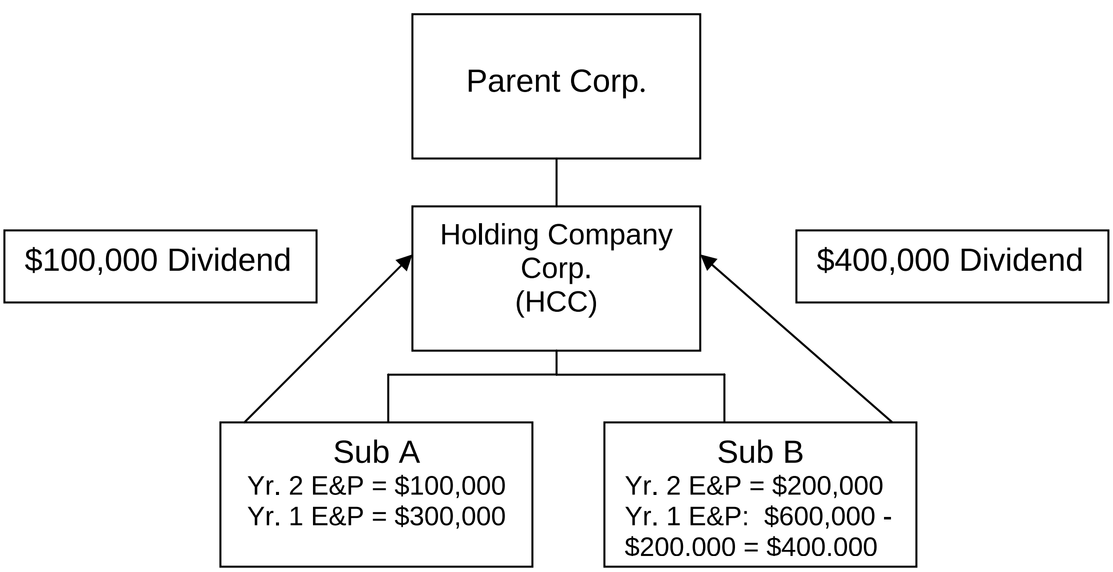
The Year 1 example below illustrates current law and the Year 2 example shows how the unintended inclusion of the same income twice may occur between members of a unitary business when a corporation is newly formed.

Current Law Example: Year 1



In Year 1, Parent Corp. and Subs A and B were members of a combined unitary business. Sub A had current year earnings and profits (E & P) of $300,000 and Sub B had E & P of $600,000. Sub B paid Parent Corp. a dividend equal to $200,000, and Parent Corp. eliminated the $200,000 dividend from taxable income because the dividends were paid out of earnings and profits when Parent Corp. and Sub B were members of a unitary business.

Newly Formed Corporation Example: Year 2



In Year 2, Parent Corp. forms a new subsidiary, HCC. Sub A pays HCC a $100,000 dividend and Sub B pays HCC a $400,000 dividend. The combined business income of Parent Corp, Sub A, and Sub B is included in a California combined unitary business. HCC may eliminate from income the $100,000 dividend received from Sub A because the dividend was paid from earnings and profits (year 2) when HCC and Sub A were members of a combined unitary business. HCC may eliminate from income only $200,000 of the $400,000 dividend received from Sub B because only $200,000 of the dividend was paid from earnings and profits accumulated when HCC and Sub B were members of a combined unitary business (year 2). The other $200,000 of dividend was paid from Sub B's earnings and profits from a year before HCC became a member of the combined unitary business (year 1).

The Year 2 example illustrates when the inclusion of the same income twice may occur if a dividend is paid to a newly formed corporation in the combined unitary business. The dividends distributed in year 2 from earnings and profits were already included in income for year 1, but would again be included in income in year 2 because the newly formed corporation HCC and Sub B were not members of the unitary business in year 1. If instead HCC was never created and the dividends had been paid directly to Parent Corp., Parent Corp. could have eliminated from income the dividends received from Sub B because Parent Corp. was a member of the unitary business in Year 1.

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FRANCHISE TAX BOARD’S
PROPOSED AMENDMENTS TO AB 3078
As Amended June 19, 2008

AMENDMENT 1

On page 22, after line 22, insert:

(c)The amendments made to Section 19136 of the Revenue and Taxation Code by this act shall apply to taxable years beginning on or after January 1, 2009.